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Powell's 'Patience' Is No Substitute For A Sound Monetary Rule

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Fed Chairman Jerome Powell's decision in December to raise the federal funds target by 25 basis points, to 2.25–2.50 percent, and to continue raising rates at least twice in the new year, upset financial markets. The Dow and S&P each dropped at least 8.7 percent, logging their worst December declines since 1931.

It looked like the "Powell put" was about to end. However, as criticism of the Fed's tighter money policy mounted, Powell surprised markets early in the new year. On January 4, he told several thousand economists at the American Economic Association meeting in Atlanta, "We will be patient [in raising rates and reducing the Fed's $4 trillion balance sheet] as we watch to see how the economy evolves."

The call for "patience" was put into action on March 20th when the Federal Open Market Committee voted unanimously to maintain the Fed's 2.25–2.50 target, while signaling that 2019 would see no rate increases. Moreover, details emerged on the Fed's plan to halt its balance sheet unwind.

Given this backdrop, several issues need special attention as the Fed reviews its formulation, conduct, and communication of monetary policy throughout 2019. The major conference at the Chicago Fed this June is just the place to be asking whether patience, reliance on the "dot plot" as a communication tool, and paying interest on excess reserves are the best we can do in trying to create macroeconomic stability.[1]

Without any credible long-run rule to guide monetary policymakers, there is still much uncertainty about future policy. Another crisis could prompt a new round of large-scale asset purchases by the Fed, further intervention in credit markets, and lower— even negative—interest rates. Meanwhile, the Fed's new operating system provides a backstop for the Fed to absorb government debt without any apparent short-run inflation consequence, tempting Congress to delegate fiscal authority to the Fed.

To understand why inflation has remained low and stable, even as the Fed experimented with near-zero policy rates and three rounds of quantitative easing (i.e., large-scale asset purchases), requires knowledge of the new operating system, which became fully operational in 2015.[2] Under the new system, the Fed uses interest on excess reserves and overnight reverse repos to administratively set a range for the fed funds rate. In doing so, the Fed has divorced the size of its balance sheet from its policy interest rate target.

Prior to 2008 banks had little incentive to hold excess reserves rather than lend them out. However, when the Fed began to pay interest on excess reserves, in October 2008, banks rapidly increased their balances at the Fed—especially when the interest rate on reserves exceeded the opportunity cost of holding those reserves at the Fed. The strong demand for reserves stymied the normal monetary transmission mechanism that had operated up to then. Hence, the Fed's large-scale asset purchases increased the monetary base but did not lead to an excessive growth of broader monetary aggregates or runaway inflation.

Today, the Fed continues to hold a large portfolio of longer-term Treasuries and mortgage-backed securities, and interest rates are still low historically. In 2000, the real (i.e., inflation adjusted) fed funds rate was 4 percent, now it is 0.25 percent. In this sense, the "stance of monetary policy is extremely stimulative," according to Greg Ip.[3] By promising to hold rates "lower for longer" and to maintain the size of its massive balance sheet, the Fed continues to signal that a primary goal of policy is to support asset prices and encourage risk taking. Yet neither objective is found in Section 2A of the Federal Reserve Act, which states:

The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.

Fed officials need to consider what Vincent Reinhart, chief economist and macro strategist at Mellon Investments, calls "the normative issue of the appropriateness of a large and lingering Fed footprint in markets." In a forthcoming article in the *Cato Journal*, he argues:

The revealed preference of policymakers is that they do not have sufficient confidence in market mechanisms or respect for the role of risk in directing the efficient allocation of resources. A healthier respect for both would place stricter limits on the extent to which a central bank leans against financial market volatility than was the case. The problem is that the precedent lowers the bar for future intervention and leaves the Fed operating under too large an ambit in our market economy.[4]

A promise of "patience" is not a substitute for a credible, long-run monetary rule in bringing about macroeconomic stability and reducing regime uncertainty. Policymakers need to recognize the limits of monetary policy in generating economic growth, protect the long-run purchasing power of the dollar, and let markets determine the allocation of credit.

The lack of any systematic policy rule to guide long-run decisions has increased regime uncertainty.[5] Policymakers err by paying too much attention to short-run remedies and too little attention to the long-run consequences of current decisions. A rules-based approach to monetary policymaking needs to be part of the discussion at the Fed's June meeting.

The case for rules versus discretion in the conduct of money policy was well stated by Karl Brunner, a cofounder of the Shadow Open Market Committee, in 1980:

We suffer neither under total ignorance nor do we enjoy full knowledge. Our life moves in a grey zone of partial knowledge and partial ignorance. [Consequently], a nonactivist [rules-based] regime emerges . . . as the safest strategy. It does not assure us that economic fluctuations will be avoided. But it will assure us that monetary policymaking does not impose additional uncertainties . . . on the market place.[6]

When Chairman Powell meets with his colleagues in June he should recall Brunner's advice and consider that, while patience is a good virtue when roaming in the dark, it is not a good rule to reduce regime uncertainty.

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